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IN THE

Supreme Court of the United States

OCTOBER TERM, 1953

No. 516

CHEMICAL BANK & TRUST COMPANY,

Petitione

v.

PRUDENCE-BONDS CORPORATION (New Corporation), *et al.*,

Respondent

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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CHEMICAL BANK & TRUST COMPANY,

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Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioner, Chemical Bank & Trust Company, prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit (RB. 165),[1] reversing the judgment of the District Court for the Eastern District of New York (R. 11-23).

Opinions Below

The opinion of the District Court (R. 250-267) is not yet reported. The opinion of the Court of Appeals (RB. 142-164) is reported at 207 F. 2d 67.

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[1] The letter "R." refers to pages of the Appendix to Brief of Objectors—Appellants (grey cover).

The letters "RW." refer to pages of the Appendix to Briefs of Chemical Bank & Trust Company, as Trustee (white cover).

The letters "RB." refer to pages of the Appendix to Brief of Prudence-Bonds Corporation, *et al.*, as Appellees (blue cover), in which the proceedings in the Court of Appeals are bound.

Jurisdiction

The judgment of the Court of Appeals was entered on August 20, 1953 (RB. 165). A petition for rehearing, timely filed on September 4, 1953 (RB. 173), was denied without opinion on October 5, 1953 (RB. 197). The jurisdiction of this Court is invoked under 28 U. S. C. §1254(1).

Question Presented

Petitioner served as trustee of a trust fund securing one of a series of bond issues of Prudence-Bonds Corporation, which was reorganized under former Section 77B of the Bankruptcy Act. The instant proceeding arises in connection with the accounting by petitioner in proceedings in the bankruptcy court. As was uniformly recognized below, petitioner as trustee acted at all times in good faith in connection with every transaction challenged by respondents in the accounting, and there was not the remotest suggestion that any action was taken by petitioner for its own gain or profit (R. 16, 17, 240; RB. 156).

Nonetheless, more than 20 years after the last of the transactions challenged by respondents in the accounting, the Court of Appeals—rejecting the settled agreement of the parties—disregarded the provisions of the indenture and surcharged petitioner over $1,700,000.

The question presented is:

> Where a debtor and a trustee execute a trust indenture securing an issue of corporate bonds

and, throughout the trust administration, in good faith adopt and act upon the reasonable terms of the agreement (with respect to such matters as the terms on which excess collateral may be withdrawn from the trust fund; the right to rely on the debtor's certificates as to the status of collateral in the trust fund; and the protection accorded by express exculpatory provisions), may the Court of Appeals disregard the agreement of the parties and the applicable law of the State of New York and surcharge the trustee on the basis of the court's own views of socially desirable standards, developed long after the fact.

The question is presented against the background of a sharp intra-circuit conflict between this case and another recent decision of the Court of Appeals for the Second Circuit, concerned with a substantially identical Prudence-Bonds trust indenture and involving the same threshold issue as to the standards applicable to a trustee under a trust indenture.

In *Prudence-Bonds Corp.* v. *State Street Trust Company,* 202 F. 2d 555 (2d Cir., March 1953), *cert. denied* October 12, 1953, 22 U. S. Law Week, p. 3091, 74 S. Ct. 47, the Court of Appeals exonerated the bank trustee, State Street Trust Company, from liability for substantial surcharges. The court held, first, that the intent of the trustee and the debtor, as expressed in their agreement, is controlling and, second, that the exculpatory provisions of the trust agreement exonerated the bank trustee from liability.

In the case at bar, decided only five months later by a different panel of the Court of Appeals, directly contrary principles were adopted. The settled mean-

ing of the trust agreement, adopted and acted upon by the parties in good faith, was specifically disregarded by the court; and identical exculpatory provisions were denied application.

This conflict culminates a continuing and irreconcilable divergence in the views of the various panels of the Court of Appeals for the Second Circuit. One group of judges holds the position, exemplified by the decision in the *State Street Trust Company* case, that the reasonable agreement of the parties to a trust indenture is properly controlling. Other judges of the Second Circuit, as shown by the decision in the case at bar, take the position that the reasonable agreement of the parties can and should be disregarded, and be replaced by the judges' own concepts of the scope of the trustee's responsibilities.

Statement

This case involves an accounting submitted to the reorganization court by a corporate trustee for one of the issues of Prudence-Bonds—a significant stage in the important Prudence-Bonds bankruptcy and reorganization proceedings which have been the subject of litigation in this Court [see *Prudence Realization Corp.* v. *Geist,* 316 U. S. 89 (1942)] and have been before the Court of Appeals for the Second Circuit for nearly two decades.

Prudence-Bonds Corporation (hereinafter referred to as the "Debtor") was engaged in the business of making loans secured by mortgages on real property. To finance its lending operations the Debtor issued and sold to the public eighteen series of its Prudence-Bonds, each series being secured by a group of mort-

gages and other collateral which were deposited with a bank trustee under a trust agreement (R. 3). Payment to holders of the bonds was also guaranteed by the Prudence Company, Inc., an affiliate of the Debtor (R. 318-323).

The Debtor filed, in 1934, its petition for reorganization under former Section 77B of the Bankruptcy Act. In 1936, a plan of reorganization was approved for Prudence-Bonds, Fifteenth Series, of which Petitioner (hereinafter sometimes referred to as the "Trustee") was successor trustee. Pursuant to the order of the reorganization court (R. 26, 27), the Trustee filed its account, as Trustee under the Fifteenth Series, and prayed for a judicial settlement and approval (R. 34-54).

Objections were filed by the reorganized debtor, Prudence-Bonds Corporation (New Corporation), the reorganization trustees of the Debtor, and certain individual bondholders (R. 59-70). These objections were referred to a special master for hearing. The facts adduced at the hearings, material to the present petition, are as follows:

Each Prudence-Bond, Fifteenth Series, explicitly provided that the bonds were secured under a trust agreement; that the rights and remedies of the Trustee, the Debtor and the holders of the bonds were governed by the trust agreement; and that the trust agreement was incorporated into the bond.[2]

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[2] The bond provided: "This bond is one of a duly authorized issue of bonds of the Corporation known as Prudence-Bonds, Fifteenth Series, all issued and to be issued from time to time, under and equally secured by a certain Trust Agreement, dated October 1, 1928, entered into by and between the Corporation and United States Mortgage and Trust Company [petitioner's predecessor], as Trustee. Reference is hereby made to said Trust Agreement for a description of the 'Trust Fund' created to

Plan of Trust Agreement Securing the Bonds

The fundamental plan of the trust agreement between the Debtor and Trustee was that the face amount of the mortgages in the trust fund should equal, but need not exceed, the face amount of the Fifteenth Series Bonds outstanding; and that the mortgages and the cash collected from mortgagors in payment of the mortgages were to be used as a revolving fund to pay off the bonds as they matured serially.

Under the trust agreement the Debtor (and its affiliate, Prudence Company, Inc., as Guarantor) was responsible for the servicing of the mortgages and other collateral in the trust fund. The Debtor collected both interest and principal on the mortgages. The Debtor was permitted to retain the interest, but it was obligated to pay the principal to the Trustee in the month following such collection (R. 282, 299, 300).[3]

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secure the payment of the principal and interest of such bonds, the nature of the securities constituting the 'Trust Fund', the rights and remedies of the Trustee and of the respective holders of said Prudence-Bonds, the rights of the Corporation and The Prudence Company, Inc., and the terms and conditions under which said bonds are secured, issued and guaranteed and said Trust Agreement is hereby made a part hereof as if herein at length set forth" (R. 288).

[3] Under the agreement the Debtor was required to furnish the Trustee with monthly written statements showing the amounts of principal collected on mortgages in the trust fund. In connection with this informational summary, the agreement provided that the "Trustee shall be under no duty to take any action upon any such statement or to see to the receipt thereof by it" (R. 300). The trust agreement contained no provision for a statement reporting collections of interest on mortgages, since the Debtor was entitled to retain such interest.

The trust agreement also gave the Debtor the right to enforce covenants and agreements in the mortgages, to institute foreclosure actions, to alter or modify the terms of any mortgage, etc. (R. 282, 283).

In order to enable the Debtor to use the proceeds of the collections to pay off its bonds as they matured, the Debtor had the right to deliver to the Trustee, in lieu of principal collections in cash, an equivalent amount of bonds for cancellation (R. 300).

This gave the Debtor two alternative methods of using the proceeds from its collections to pay off its bonds: (1) the Debtor could deposit monthly with the Trustee cash collections of principal upon the mortgages (R. 300), pay serially maturing bonds with the Debtor's own money, turn these bonds in to the Trustee for cancellation and then reimburse itself by withdrawing cash from the trust fund to the extent of the excess of the face amount of collateral over the face amount of the bonds outstanding (R. 285); or (2) the Debtor could retain the cash collections of principal upon the mortgages and surrender to the Trustee an equal amount of bonds maturing within six months, in lieu of such cash (R. 300).

Right to Substitute and Withdraw Collateral

Reflecting this plan for an effective revolving fund and the obvious business need for flexibility as to the collateral making up the fund at any particular time, the agreement provided in detail for the substitution and withdrawal of securities, or other excess collateral (R. 283-285).

Under the agreement the Debtor could withdraw any security or other collateral, including cash, from the trust fund at any time when the principal amount of the trust fund exceeded the par value of the Fifteenth Series Bonds outstanding, but only to the ex-

tent of such excess. In connection with any such withdrawal, the trust agreement provided that if any of the securities deposited in the trust fund "shall be in default in the *payment of principal for more than 60 days* the Corporation shall be permitted to withdraw only such securities . . . as shall be so in default . . ." (R. 284). (Emphasis supplied.)

Giving effect to the clear intention of the agreement which they had made and drafted, the Debtor and the Trustee, in determining whether withdrawals could be made from the trust fund, excluded any mortgage in default in the payment of principal for more than 60 days, in their computation of the amount of the trust fund. In keeping with the agreement, mortgages in default for less than the 60 day period or in default solely as to interest were included in the trust fund in determining whether there was excess collateral subject to withdrawal (RW. 70, 141, 142, 137, 138, 208, 209; R. 225, 199-201).

Certificates of Non-Default

The trust agreement also provided that the "Trustee may accept as conclusive the written statement of any officer of the Corporation as to whether or not any securities deposited in the trust fund are in default in the payment of principal or interest" (R. 284). The Trustee was thus entitled to release excess cash to the Debtor upon a certificate of an officer of the Debtor that the state of the trust fund satisfied the conditions for such release.

This provision was necessary and reasonable. Since the Debtor was entitled by the trust agreement to

collect principal and otherwise service the mortgages without interference,[4] there was no other practical way for the Trustee to know, at any particular time, what collections of principal had been made, what steps were being taken to enforce mortgages and whether or not mortgages in the trust fund were in principal default.

The terms of the trust agreement, summarized above, were reasonable, essential to the effective functioning of the revolving fund under the trust agreement, and in no sense contrary to public policy either of the Federal Government or the State of New York.[5] The Trustee and the Debtor uniformly acted in conformity with the release provisions. During the period 1929-1931, the Debtor withdrew and the Trustee released approximately $1,957,700 in thirty separate instances, under the terms of the agreement (R. 46). In connection with each release of excess cash collateral here relevant, except one, the Debtor furnished and the Trustee acted upon a certificate of an officer of the Debtor (R. 114).

Furthermore, before permitting any release, the Trustee in good faith made a careful check of its records, ascertaining that no mortgage was, as required under the release clause of the trust agreement, "in default in the payment of principal for more than 60 days" (R. 226, 227, RW. 115-117). It therefore believed that the recitals in the certificates

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[4] These rights of the Debtor and Guarantor were absolute, and were not to be interfered with unless and until the Guarantor failed to fulfill some obligation in its guarantee of the Fifteenth Series Bonds (R. 301, 302).

[5] As set forth, *infra*, at pp. 18-19, the immunity provisions contained in the trust agreement which were rejected below are expressly authorized by the Federal Trust Indenture Act of 1939.

of non-default were correct, and that the Debtor was entitled to withdraw the excess cash collateral.

Objections to Trustee's Account

Of the three objections filed to the Trustee's account, the First Objection is not here material since it was dismissed by the District Court (R. 252) and its dismissal affirmed by the Court of Appeals (RB. 148). The Second Objection, which involves the bulk of the claimed surcharge and is most basic to the question presented in this Petition, challenged the propriety of twelve releases of excess cash collateral to the Debtor, totalling $1,045,250, between October 31, 1930 and August 17, 1931, on the alleged ground that at the time of each release a mortgage in the trust fund was "in default in payment of principal for more than sixty (60) days" (R. 61). The Third Objection was based on the claim that the bank had allowed the Debtor to retain certain collections of mortgage principal, and in lieu of such cash had accepted from the Debtor an equivalent principal amount of bonds for cancellation (R. 62).

The Decision of the District Court

On objections by all parties to the special master's report (RW. 1, R. 241), District Judge Inch dismissed the First Objection, reduced the surcharge recommended by the master under the Second Objection from $1,045,250 to $142,500, and increased the surcharge under the Third Objection from $3,966.68 to $16,716.66 (R. 15-22).

The central issue before the District Court—as here—related to the Second Objection. The District Court,

applying the terms of the trust agreement between the Debtor and the Trustee as acted upon by them over the years, determined that on June 4, 1931 the Trust Fund contained mortgages not "in default in the payment of *principal for more than 60 days*" more than equal to the bonds outstanding[6] (R. 257, 255, 223, 224).

Consequently, the District Court held that date to be a "clear day" on which the trust fund was clearly in balance so that no diminution of the trust fund had resulted from prior withdrawals, even if they had been unauthorized. The District Court therefore denied any surcharge for six releases of cash prior to June 4, 1931 because, on that date, the trust fund contained excess cash collateral available for authorized withdrawal, restoration of prior withdrawals had been made, and any damage to the trust fund had been cured. In allowing a surcharge of $142,500 to stand for withdrawals after the "clear day", the District Court refused to give effect to the certificates of non-default upon which the Trustee relied.

The District Court, rejecting the Trustee's reliance on the trust agreement's exculpatory provisions, sustained the Third Objection on the ground that the Trustee should not have allowed the Debtor to retain

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[6] In so concluding, the District Court pointed out the significant difference between the release clause of the trust agreement involved here, which restricts withdrawals and substitutions of collateral if a mortgage in the Trust Fund was in default in the payment of *principal for more than 60 days* and that involved in an earlier case dealing with the Fifth and Ninth Series of Prudence-Bonds [*President and Directors of Manhattan Co.* v. *Kelby*, 147 F. 2d 465 (2d Cir. 1944, 1945); cert. den. 324 U. S. 866, 65 S. Ct. 916 (1945)], where the restrictive provision became operative if a mortgage were in default in the payment of *principal*, with no provision disregarding defaults of 60 days or less (R. 256-7).

certain collections of mortgage principal and, in lieu thereof, have accepted bonds for cancellation.

The Decision of the Court of Appeals

On cross appeals, the Court of Appeals affirmed the judgment of the District Court with respect to the First and Third Objections, reversed the District Court's judgment on the Second Objection and sustained the Second Objection in its entirety. The total surcharge imposed was $1,061,966.66, plus interest of more than $700,000. The Court of Appeals did not disturb the joint findings of the Trustee's good faith made by the special master and the District Court (RB. 156).

With respect to the Second Objection, however, the Court of Appeals rejected the agreement made and acted upon by the Debtor and the Trustee, and accepted by the District Court, and propounded an interpretation of the trust agreement under which releases of cash from the trust fund were prohibited unless mortgages not in default *in interest or principal for any duration* were at least equal to the bonds outstanding. By so disregarding the terms of the trust agreement, as continuously acted upon by the parties, the Court of Appeals rejected the conclusion that a "clear day" existed on June 4, 1931 and surcharged the Trustee for the withdrawals made prior to that date.

The Court further decided that the certificates of non-default did not absolve the Trustee, in part on the ground that the Trustee had not accepted them as conclusive, but on the concluding note that the certificates were inadequate because they did not

mention the status of the interest payments, which became material under the court's new interpretation of the release provisions.

Reasons for Granting the Writ

I

Petitioner—because of the plain injustice of the surcharge imposed below and because, as a prominent corporate trustee, it requires a determination for the effective performance of its functions in the future—seeks here an authoritative ruling by this Court as to the basic legal standards to be applied in an extremely important and sensitive area: the responsibilities of the corporate trustee under a trust indenture.

The Court of Appeals applied to petitioner a concept that the express intent of the parties to a trust agreement, entered into in good faith and consistently followed by the parties during the trust administration and in no way contrary to public policy, may be baldly disregarded in measuring the Trustee's obligations. Continued application of this concept by the Court of Appeals can result only in serious disruption of settled and eminently proper financial arrangements.

It is the basic legal standards that govern in this area upon which review is sought; the petition does not seek review by this Court of the facts below. Quite aside from the conflict in the decisions in the Court of Appeals for the Second Circuit, the decision below calls for review by this Court.

II

A. As disruptive as would be the influence of the decision below standing alone, the effect is immeasurably heightened by the sharp conflict of the decision with that of another panel of the Court of Appeals for the Second Circuit, handed down just five months before the decision in this case, in *Prudence-Bonds Corp.* v. *State Street Trust Company*, 202 F. 2d 555 (2d Cir., March 1953), *cert. denied*, October 12, 1953, 22 U. S. Law Week, p. 3091, 74 S. Ct. 47. The *State Street Trust Company* case and this decision are incompatible on the basic question of the effect to be given to the intent of the parties to a trust agreement, and their construction of the agreement.

In the *State Street Trust Company* case, the Prudence-Bonds trust agreement provided, in addition to the primary guarantee of payment of the bonds, for a secondary guarantee by Prudence Company, Inc. of payment of any mortgages in the trust fund in default for 18 months. State Street Trust Company, as trustee, took no action to enforce this guarantee although the largest mortgage in the trust fund was in default for the 18-month period. The Court of Appeals held that the failure of the trustee to take steps to enforce the secondary guarantee was excused by the exculpatory clauses of the indenture. As the opinion by Judge Learned Hand (joined by Judge Swan, with Judge Frank dissenting) so strikingly reveals, the basic approach of the Court was to determine the intent of the debtor and the trustee in their drafting of, and operations under, the trust agreement. The court then gave effect to that intent, and absolved the trustee.

In this case, a different panel of the Court of Appeals for the Second Circuit (Judge Clark writing, joined by Judges Chase and Frank) determined the identical issue of the meaning of the trust indenture in precisely the opposite manner, and reached a squarely conflicting result. As indicated above, it was uncontroverted that the trust agreement, as consistently followed by the Trustee and the Debtor, excluded only those mortgages in default in the payment of principal for more than 60 days in computing the value of securities in the trust fund in connection with the withdrawal of excess collateral. Here was the explicit, clear intent of the parties, as expressed in the trust instrument and as confirmed by their unbroken pattern of conduct in the administration of the trust.

In sharp contrast with the court in the *State Street Trust Company* case, the panel of the court sitting in this proceeding flatly ignored the intent of the parties and the meaning they had placed on the provision. The court's basis for this departure from precedent was:

> "It may be noted that the Bank urges vigorously a settled construction of the trust agreement made and acted upon by the parties at the time, contrary to our conclusion and in accord with the view of the district judge. But the parties were the Trustee and the Debtor corporation; overlooked entirely are the bondholders for whom the protective provisions were drawn" (207 F. 2d 67, 77).

Further emphasizing the divergence between the two cases is the fact that Judge Hand, in the *State Street Trust Company* case, specifically considered the interest of the bondholders, used as the basis for

disregarding the agreement here, and concluded that protection of the bondholders' interest did not require nor justify the court's refusing to give effect to the agreement between the debtor and trustee. See 202 F. 2d 555, 564.

The conflict between the case at bar and the *State Street Trust Company* case culminates a striking and continuing divergence in the views of various panels of the Second Circuit on the basic rules applying to trust agreements and the responsibilities of indenture trustees. The diverse views of the various judges of the Court of Appeals for the Second Circuit are evidenced in *Clarke* v. *Chase National Bank,* later entitled *Dabney* v. *Chase National Bank,* which came before the court three times: 137 F. 2d 797 (1943); 196 F. 2d 668 (1952); 201 F. 2d 635 (1953). Seven conflicting opinions were handed down in that single litigation and in the 1952 decision there were three conflicting opinions by the three judges composing the same panel.

In one of his opinions in this *Chase Bank* proceeding, Judge Learned Hand said:

> "As to the case against the trustee upon the merits, I agree that ordinarily a trustee does not default in its duties by mere inaction; certainly not when it has protected itself by such covenants as these. Article VI, Sec. 12, and Article IX, Sec. 1, are in the standard pattern of immunity; I do not question that they protect the trustee in most cases; . . ." (137 F. 2d 797, 802).

Judge Clark, who twice dissented in the *Chase Bank* litigation, was in favor of disregarding the

agreement between the parties and holding the trustee responsible for all claims advanced by

> ". . . applying the normal public interpretation of 'trustee' to the hitherto anomalous bond indenture trustee . . ." (201 F. 2d 635, 641, 643).

This view advanced by Judge Clark was rejected in the *State Street Trust Company* case. The acute divergence of views among the judges was, however, brought into focus in the majority opinion by Judge Learned Hand and the dissent of Judge Frank. In giving effect to the express provisions of the trust agreement and refusing to surcharge the trustee, Judge Hand said:

> ". . . indentures containing such clauses have been uniform up to the present time; and any abuses that they have permitted have neither induced legislatures to intervene, nor courts to make an exception. . . . It may be that in time courts will take a more protective view, though obviously there are two sides to the question; but to us it seems that a custom that has secured such long recognition should be left for correction to legislative inquiry and action" (202 F. 2d 555, 564).

Judge Frank, dissenting, took the converse view with respect to determining the trustee's position under the trust agreement:

> ". . . With reference to contracts, such a precept [that the intent of the parties governs] has come to be recognized as nothing but a fiction used to sugar-coat the fact that the court, entirely without regard to the parties' intention, is imposing on them (or one of them) an obligation

> based on considerations of public policy, *i. e.*, the court's notion of justice, of decent, socially desirable conduct . . ." (202 F. 2d 555, 564, 568).

It was this subjective approach—at war with the basic principle that in construing a contract a court seeks to discover what the parties intended[7]—that was adopted in Judge Clark's opinion in the case at bar. The position taken is that the agreement between the parties can and should be disregarded and be replaced by the particular judges' own fluid concepts of the scope of an indenture trustee's obligations. To apply Judge Frank's blunt language in his *State Street Trust Company* dissent, the petitioner has been surcharged over $1,700,000 for an obligation based on "the court's notion of . . . socially desirable conduct" and "entirely without regard to the parties' intention."

The disruptive effect of applying such illusive principles can be briefly and graphically illustrated. Applying these highly personal views of socially desirable conduct, the panel of the Second Circuit which sat in the case at bar refused to give effect to the certificates of non-default which the Trustee was entitled to rely upon under the trust agreement. These immunity provisions were disregarded even though they are expressly authorized by the Federal Trust Indenture Act of 1939, 53 Stat. 1149, 15 U. S. C. §77aaa, *et seq.*

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[7] "There is no surer way to find out what parties meant, than to see what they have done." *Insurance Co.* v. *Dutcher*, 95 U. S. 269, 273 (1877). See also: *Nicoll* v. *Sands*, 131 N. Y. 19, (1892) 29 N. E. 818; *City of New York* v. *New York City Ry. Co.*, 193 N. Y. 543 (1908) 86 N. E. 565; *Carthage Tissue Paper Mills* v. *Village of Carthage*, 200 N. Y. 1 (1910) 93 N. E. 60; *Halperin* v. *McCrory Stores*, 207 App. Div. 448 (1923); aff'd. 239 N. Y. 547 147 N. E. 189; and *Irving Trust Company* v. *Natica, Lady Lister-Kaye*, 157 Misc. 32 (1935).

That Act was passed, after extended study by the Securities and Exchange Commission and detailed legislative inquiry,[8] in order:

> ". . . to bring all indenture trustees . . . up to the high level of diligence and loyalty now maintained by the more conscientious trust institutions . . . These objectives are to be accomplished by establishing statutory standards to which trust indentures must conform."[9]

Significantly, the Trust Indenture Act, designed to curb and remove the possibilities of abuse, authorizes a trust indenture provision that a trustee which acts upon certificates of the obligor shall not be liable for such action except for bad faith.[10]

Nonetheless, by the application of the theories espoused by some of the judges of the Second Circuit,

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[8] See, *e. g.*, Hearings Before Subcommittee of Committee on Interstate and Foreign Commerce, U. S. House of Representatives, on H. R. 10292, 75th Cong., 3d Sess. (1938) and on H. R. 2191 and H. R. 5220, 76th Cong., 1st Sess. (1939); Hearings before Subcommittee of Committee on Banking and Currency, U. S. Senate, on S. 477, 76th Cong., 1st Sess. (1939); Securities and Exchange Commission, Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees, Part VI, Trustees Under Indentures (1936).

[9] Commissioner E. P. Eicher of the Securities Exchange Commission, in Hearings Before Subcommittee of Committee on Banking and Currency, U. S. Senate, on S. 477, 76th Cong., 1st Sess., p. 32 (1939).

[10] The Trust Indenture Act (53 Stat. 1171, 15 U. S. C. §77ooo) provides:

"(a) The indenture to be qualified may provide that, prior to default (as such term is defined in such indenture)—

(1) the indenture trustee shall not be liable except for the performance of such duties as are specifically set out in such indenture; and

(2) the indenture trustee may conclusively rely, as to the truth of the statements and the correctness of the opinions

the certificates of non-default—*specifically recognized as proper and desirable by the Congress after extended study*—are swept aside.

The issue is clearly drawn—is the standard exemplified by Judge Learned Hand's opinion in the *State Street Trust Company* case to prevail so that reasonable rules of conduct can be ascertained and followed, or are the highly personal norms of particular judges to override the terms of the agreement, the policy adopted by the Congress, and the realities and needs of the financial markets.

B. The intra-circuit conflict makes this case an appropriate one for review by this Court. *John Hancock Insurance Co.* v. *Bartels,* 308 U. S. 180, 181 (1939) ("conflict in the rulings of the Court of Appeals of the Fifth Circuit, due to the differing views of the judges composing the court in the cases cited"); *Dickinson* v. *Petroleum Conversion Corp.,* 338 U. S. 507, 508 (1950) (intra-circuit conflict in Second Circuit given as sole ground for granting certiorari); *Maggio* v. *Zeitz,* 333 U. S. 56, 59-60 (1948) (pointing out that the problem presented more difficulties in the Second Circuit than elsewhere and that these difficulties were reflected in conflicting views within the Court of Appeals).

The need to resolve the conflict is particularly compelling in this case. The Court of Appeals for the

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expressed therein, in the absence of bad faith on the part of such trustee, upon certificates or opinions conforming to the requirements of the indenture;

but such indenture shall contain provisions requiring the indenture trustee to examine the evidence furnished to it pursuant to section 77nnn of this title to determine whether or not such evidence conforms to the requirements of the indenture."

Second Circuit has been long recognized as perhaps the most important commercial tribunal in the United States. The basic issue on which the conflict exists concerns both the multitude of individuals throughout the country, who own billions of dollars of corporate bonds secured by indentures, and the many banks and trust companies which serve the public as corporate trustees.[11] Most of these bond issues are administered within the jurisdiction of the Court of Appeals for the Second Circuit by New York banks, as corporate trustees. Moreover, as in the *State Street Trust Company* case, banks located in other parts of the country may be compelled to account in the Federal courts in New York.

The business community looks to the decisions of the Second Circuit for the norms of conduct governing these extremely widespread and substantial transactions under trust indentures. But the present state of the decisions in the Second Circuit—climaxed by the decision in this case, the last of the Prudence-Bonds accountings—represents the antithesis of the standards and guides so vitally needed. The resulting confusion calls for this Court's intervention.

To remove the intra-circuit conflict, the court below, under the principles enunciated in *Western Pacific Railroad Corp.* v. *Western Pacific Railroad Co.*, 345

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[11] In 1934 securities outstanding under trust indentures totalled $37,000,000,000. Posner, The Trustee and the Trust Indenture, 46 Yale L. J. 737, 738 (1937). In 1944-1949 new corporate debt represented by bonds totalled $26,000,000,000. Corbin, The Subsequent Bondholder and the Delinquent Trustee, 51 Col. L. Rev. 813, n. 3 (1951).

U. S. 247 (1953), should have heard the case *en banc* under 28 U. S. C. § 46(c). As Chief Justice Vinson said for the Court in the *Western Pacific* case:

> ". . . The *en banc* power, confirmed by § 46(c), is, as we emphasized in the *Textile Mills* case, a necessary and useful power—indeed too useful that we should ever permit a court to ignore the possibilities of its use in cases where its use might be appropriate.
>
> * * * *
>
> ". . . A court may take steps to use the *en banc* power sparingly, but it may not take steps to curtail its use indiscriminately . . ." (345 U. S. 260, 261).

In similar vein, Mr. Justice Frankfurter observed:

> "Rehearings *en banc* by these courts, which sit in panels, are to some extent necessary in order to resolve conflicts between panels. This is the dominant concern . . ." (345 U. S. 270).

Mr. Justice Jackson said:

> ". . . In cases of intracircuit conflict or other exceptional situations which actually demand the attention of the full court, the judges of a court should be trusted to convene on their own initiative . . ." (345 U. S. 273).

In this instance, however, it must remain for this Court to resolve the apparently irreconcilable conflict in the court below, for as pointed out by Mr. Justice Jackson in his *Western Pacific* opinion, "the Second Circuit simply does not sit *en banc*" 345 U. S. 274, n. 2.

As a result of the conflicting rulings of the Second Circuit, indenture trustees do not know whether their duties are measured by the agreements under which they act or by the changing and elusive notions of a trustee's responsibilities, as propounded by various panels of the Court of Appeals.

Unless this Court determines the basic issues presented by this petition, indenture trustees will necessarily be deterred from acting, for they cannot proceed with certainty and cannot protect themselves during the administration of their trusts. As Judge Learned Hand cogently stated in *Dabney* v. *Chase National Bank, supra*:

> ". . . The law ought not make trusteeship so hazardous that responsible individuals and corporations will shy away from it. As we said in *York* v. *Guaranty Trust Co.*, 2 Cir., 143 F. 2d 503, 514: 'Of course, the courts should not impose impractical obligations on a trustee. . . .' It would be likely to impede the legitimate business of trustees far more than it would protect their beneficiaries . . ." (196 F. 2d 668, 675).

III

In addition to the conflict in the decisions of the Court of Appeals for the Second Circuit, the decision below, in failing to give effect to the terms of the indenture, disregarded applicable state law. In *Hazzard* v. *Chase National Bank*, 159 Misc. 57; aff'd. 257 App. Div. 950; aff'd. 282 N. Y. 652, 283 N. Y. 682;

cert. denied, 311 U. S. 708, the corporate trustee under a trust indenture permitted a substitution of collateral in the trust fund upon a certificate of the obligor, where the substituted securities were of doubtful value. Since the trustee acted upon the certificate of the obligor, it was held exonerated by the exculpatory provisions of the indenture. The court said:

> ". . . But the trustee cannot be held to a contract different from the one actually adopted . . .
>
> ". . . It is correctly urged by the defendant that the trust indenture did not impose upon the defendant any duty of investigating the truth or falsity of the earnings certificate (159 Misc. 71).
>
> * * * *
>
> "With this trust indenture and the exculpatory clauses thereof, however, a different picture is presented. Similar exculpatory clauses have been upheld time and time again as valid and not contrary to the public policy of this State. (*Benton* v. *Safe Deposit Bank of Pottsville,* 255 N. Y. 260; *Green* v. *Title Guarantee & Trust Co.,* 233 App. Div. 12; aff'd., 248 N. Y. 627; *Hunsberger* v. *Guaranty Trust Co.,* 164 App. Div. 740; aff'd., 218 N. Y. 742; *Greene* v. *Continental Bank and Trust Co.,* 267 *id.* 519.) In the *Benton* case the duty of the trustee was held to be strictly measured and limited by the agreements contained in the Indenture (*id.,* p. 79).
>
> * * * *
>
> "The defendant in the case at bar is protected by the trust agreement from any liability in relying, as he did, upon the certificates furnished . . ." (*id.,* p. 80).

In surcharging the Trustee and failing to give effect to the certificates of non-default, the present case is in conflict with this clear expression of the applicable New York law.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that a writ of certiorari should be granted.

Respectfully submitted,

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December 28, 1953

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MISCELLANEOUS

Address of the late Chief Justice Vinson to American Bar Association, St. Louis Daily Record, Sept. 8, 1949, col. 7 10

IN THE

Supreme Court of the United States

OCTOBER TERM, 1953

No. 516

CHEMICAL BANK & TRUST COMPANY,

Petitioner,

v.

PRUDENCE-BONDS CORPORATION (NEW CORPORATION), ET AL.,

Respondents.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Second Circuit

BRIEF FOR RESPONDENTS IN OPPOSITION

Opinions Below

The opinion of the Court of Appeals for the Second Circuit (RB. 142-164)[1] is reported at 207 F. 2d 67.

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[1] The letter "R" refers to pages of the Appendix to the Brief below of Objectors-Appellants Prudence-Bonds Corporation (New Corporation), et al. (gray cover).

The letters "RW" refer to pages of the Appendix to the Brief below of petitioner appellant-appellee Chemical Bank & Trust Company, as Trustee (white cover).

The letters "RB" refer to pages of the Appendix to the Brief below of Objectors-Appellees Prudence-Bonds Corporation (New Corporation), et al. (blue cover), in which the proceedings in the Court of Appeals are bound.

The letter "F" refers to the Special Master's numbered findings of fact contained in his Report printed at R. 74-240.

The opinion of the District Court is not reported but is printed in the record (R. 250-267).

The opinion of the Special Master is not reported but is printed in the record (R. 74-240).

Jurisdiction

The judgment of the Court of Appeals was entered on August 20, 1953 (RB. 165). Petitioner's petition for rehearing (RB. 166-173) was denied on October 5, 1953 (RB. 198).

The jurisdiction of this Court is invoked under 28 U. S. C. § 1254(1).

Question Presented by Petitioner

The question petitioner seeks to present is whether the Court of Appeals may "disregard" the provisions of a trust agreement "and the applicable law of the State of New York and surcharge the trustee on the basis of the court's own views of socially desirable standards, developed long after the fact" (Pet., pp. 3-4).

This is not a proper question, but rather an unwarranted charge against the Court of Appeals framed in disregard of its decision. Petitioner's question assumes that this Court: (a) would consider and answer in the negative the question whether the acts for which petitioner has been surcharged were, as the Court of Appeals held, negligent and unauthorized; (b) would consider and answer in the affirmative the question whether the Court of Appeals disregarded the Trust Agreement; and (c) would consider and answer in the affirmative the question whether the Court of Appeals disregarded applicable State law.

These several further questions, which would have to be determined before reaching the question petitioner seeks

to present, should not be considered. They have not been presented by petitioner, and, necessarily, would involve review of issues of fact disputed by and found against petitioner below.

Petitioner states, "the petition does not seek review by this Court of the facts below" (Pet., p. 13). The facts below include findings of fact made by the Special Master after a protracted trial (RB. 143), and accepted by the Court of Appeals on cross-appeals, that petitioner, in committing the acts for which it has been surcharged in an amount found to be the loss to the Trust Fund, was negligent and violated express provisions of the Trust Agreement (F. 121, 212, 219-221, 232, 242; R. 163, 184, 186, 188, 190, 264-266); provisions which the Court of Appeals characterized as "explicit * * * beyond dispute" (RB. 155; 207 F. 2d 76). These findings of fact, which petitioner here accepts, conclusively negate the assumptions petitioner makes in the question it seeks to present.

Statement

The case involves the reorganization of Prudence-Bonds Corporation, Debtor, under the Bankruptcy Act, and, more particularly, a proceeding had in the reorganization court, Eastern District of New York, for the judicial settlement of the account of petitioner, Chemical Bank & Trust Company, Trustee under a Trust Agreement with the Debtor securing a Series of Prudence-Bonds known as "Fifteenth Series" (R. 24-54).

When the Debtor went into reorganization it had outstanding eighteen Series of bonds, each of which was secured by a trust fund, consisting of mortgages, cash and other securities, held by a Bank as trustee under a trust agreement with the Debtor (F. 3, 4, 20, 23; R. 124-125, 129-131). Eleven Banks were trustees of the eighteen Series

(R. 55-56). The bonds of all Series were guaranteed by The Prudence Company, Inc., an affiliate of the Debtor, which also went into bankruptcy reorganization, and, like the Debtor, was also found to be insolvent (F. 5, 8, 17, 18; R. 125-127, 129).

A Plan of Reorganization of the Debtor was confirmed which provided, in part, for a new corporation (also named Prudence-Bonds Corporation) to be owned by the bondholders, an extension of the maturity of the bonds and changes in interest provisions (F. 29, 31-35; R. 131-132). Under the Plan, one of the eleven Bank trustees became successor trustee of all eighteen Series under a Supplemental Trust Agreement with the new Prudence-Bonds Corporation (F. 37; R. 133).

Upon confirmation, jurisdiction was retained to carry out the Plan (F. 30; R. 132). To that end, the reorganization court, among other things, approved the appointment of the successor indenture trustee, approved the Supplemental Trust Agreement, and directed the original indenture trustees to transfer the trust funds to the successor trustee and to account in the reorganization court for their acts as trustees (F. 37, 41, 43; R. 133, 136).

Each of the indenture trustees submitted to the jurisdiction of the reorganization court, filed its account and petitioned for the judicial settlement thereof and a discharge from all liability as trustee (F. 45; R. 137). The jurisdiction of the reorganization court over the accountings was upheld in *Central Hanover B. & T. Co.* v. *President & Directors of the Manhattan Co.* (C. A. 2), 105 F. 2d 130. On the mandate of the Court of Appeals in that case, the reorganization court decreed that it had and thereby exercised "full, complete and exclusive jurisdiction" to settle the accounts and to hear and determine all objections thereto (R. 55-56).

Objections to the accounts were timely filed and there then ensued much further litigation in the proceedings

which resulted in four other decisions of the Court of Appeals, each of which this Court declined to review.[2]

The instant case, involving petitioner, Chemical Bank & Trust Company, Trustee of Prudence-Bonds, Fifteenth Series, is the last of these eighteen accountings (RB. 142).

The Trust Agreement securing the Fifteenth Series was made in New York in December, 1928, between the Debtor and United States Mortgage and Trust Company, as Trustee (R. 273, 317). In June, 1929, prior to the date of any transaction herein involved, petitioner succeeded United States Mortgage and Trust Company by merger (R. 373).

A summary of various provisions of the Trust Agreement is contained in the Master's Report (R. 79-84) and in the opinion of the Court of Appeals (RB. 144-147; 207 F. 2d 70-72). We shall later refer to certain of these provisions, including Article I, Section 6, which governed releases and substitutions of Trust Fund securities (R. 283-284). Suffice it to state here that there is no basis for petitioner's statement that the "fundamental plan of the trust agreement" was that the Trust Fund was to be "a revolving fund to pay off the bonds as they matured serially" (Pet., p. 6). The Trust Agreement created an express trust (*Manufacturers Trust Co.* v. *Kelby*, *supra*), and established a Trust Fund, consisting of bonds and mortgages, cash and other securities, "to secure the payment of" the Fifteenth Series bonds, "the performance and observance of all the covenants and conditions" of the Agreement, "for the equal and pro rata benefit and security of" the bondholders, and "for all the other uses and purposes and upon the terms" therein "declared and expressed" (R. 274-275, 286).

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[2] *Manufacturers Trust Co.* v. *Kelby* (C. A. 2), 125 F. 2d 650, cert. denied, 316 U. S. 697; *Brooklyn Trust Co.* v. *Kelby* (C. A. 2), 134 F. 2d 105, cert. denied, 319 U. S. 767; *President and Directors of Manhattan Co.* v. *Kelby* (C. A. 2), 147 F. 2d 465, cert. denied, 324 U. S. 866; *Prudence-Bonds Corp.* v. *State Street Trust Company* (C. A. 2), 202 F. 2d 555, cert. denied, ... U. S. ....., 74 S. Ct. 47.

Petitioner, like the other indenture trustees, duly filed its account, covering its acts and transactions and those of its predecessor from the inception of the Trust, and petitioned the reorganization court for the judicial settlement thereof and a discharge from all liability as Trustee (R. 34, 38). The account set forth in debit and credit form the mortgages, cash and other securities received in trust, released and disbursed, changes in securities, collections on securities, bonds authenticated, bonds cancelled and other transactions (R. 41-54).

Objections to petitioner's account were timely filed by a bondholder and by the new Prudence-Bonds Corporation and the Reorganization Trustee of the Debtor and were joined in by other bondholders (R. 59, 71; F. 55-56; R. 139-140).

The account and objections were referred to a Master to take testimony and to hear and report on the facts and the law (R. 74).

There were three objections to petitioner's account, numbered "First", "Second" and "Third" (R. 59-65), two of which, the "Second" and "Third", were ultimately sustained by the Court of Appeals which surcharged petitioner thereunder in the total sum of $1,061,966.66, plus interest at 3% (RB. 142-164; 207 F. 2d 67).

The issues raised by the objections were, in large part, issues of fact, particularly the issues, disputed by petitioner at all stages of the case below, whether Trust Fund mortgages were in default on the dates of the various transactions objected to and the length of time the mortgages remained in default. At the protracted trial before the Master, fourteen witnesses testified and approximately 190 exhibits were introduced in evidence (RB. 143). The Master's Report, which the Court of Appeals described as "thorough and comprehensive", contains 468 separately numbered findings of fact (RB. 143; 207 F. 2d 70).

FIRST OBJECTION. This objection need not be discussed since it was dismissed below (R. 84-87, 252; RB. 147-148; 207 F. 2d 72-73).

SECOND OBJECTION. This objection involved petitioner's acts on twelve dates between October 31, 1930 and August 17, 1931, in releasing to the Debtor a total of $1,045,250 of Trust Fund cash in violation of the Trust Agreement, with particular reference to the release clause, Article I, Section 6 (R. 61-62). This section authorized petitioner to release Trust Fund cash and securities in three different ways: (1) upon substitution of an equal amount of other eligible securities; (2) against delivery of an equal amount of Fifteenth Series bonds for cancellation; (3) as "excess" when the Trust Fund, properly computed, exceeded the bonds outstanding (R. 283-285). Petitioner's authority to release cash or other securities was, however, subject to three express provisos of Article I, Section 6. The first proviso prohibited all releases if the Debtor became in default in the payment of principal or interest on any of the Fifteenth Series bonds (R. 283). The second proviso required that after any release the Trust Fund contain cash, or securities not in default in the payment of principal or interest, in amount or value not less than the principal amount of bonds outstanding (R. 119, 284; RB. 149-154; 207 F. 2d 73-77). The third proviso, which the Court of Appeals found to be "explicit * * * beyond dispute" (RB. 154-155; 207 F. 2d 76), prohibited all releases of cash and non-defaulted securities if "any" mortgage collateral in the Trust Fund was "in default in the payment of principal for more than 60 days" (R. 284; RB. 154-155; 207 F. 2d 76).

The release clause, Article I, Section 6, further provided for what petitioner calls "Certificates of Non-Default" (Pet., p. 8). The provision was that petitioner "may accept as conclusive the written statement of any officer of the (Debtor) Corporation as to whether or not any securities deposited in the Trust Fund are in default in the payment of principal or interest" (R. 284).

The Master found as a fact that petitioner "did not receive, in connection with any of the releases of cash enumerated in the Second objection herein, any written statement of an officer of the Debtor as to whether or not any securities deposited in the Trust Fund were in default in the payment of principal or interest" (F. 207; R. 183). The Master further found as facts that each sum of cash covered by the Second objection was released by petitioner from the Trust Fund as "excess" without receiving anything in substitution; that on the date of each release mortgage collateral in the Trust Fund was, "to the knowledge of" petitioner, in default in the payment of principal for more than 60 days; that on the dates of certain of the releases mortgage collateral was, to the knowledge of petitioner, in default in the payment of interest; that after each release the total amount of cash and non-defaulted securities remaining in the Trust Fund was less than the principal amount of Fifteenth Series bonds then outstanding; that each of the releases of cash was unauthorized and violated both the second and third provisos of the release clause; and that petitioner, in permitting the releases, was "grossly negligent" and caused a loss to the Trust Fund of the sum of $1,045,250 (F. 145-148, 203-204, 205, 206, 211, 212, 216; R. 119, 170-171, 181-182, 184, 185).

Upon these findings of fact, the Master concluded that the Second objection should be fully sustained and surcharged petitioner thereunder in the sum of $1,045,250 (R. 237).

The District Court Judge, upon review of the Master's Report, accepted almost all of the Master's findings of fact,[3] but reduced the Master's surcharge under the Second

[3] The District Court Judge, without comment or stated reason, struck out the word "grossly" from the Master's findings that petitioner was "grossly negligent" (R. 264). It was, however, not necessary to establish gross negligence to sustain the objections; the Trust Agreement here does not contain the frequently condemned exculpatory clause relieving a trustee of liability save for gross negligence and bad faith (R. 273). The finding of gross negligence was perti-

(Footnote continued on following page.)

objection to $142,500, relying upon the decision of the Court of Appeals in *President and Directors of Manhattan Co.* v. *Kelby* (C. A. 2), *supra,* involving the accounting by the Bank Trustee of the Debtor's Fifth and Ninth Series bonds (R. 252-262).

On cross appeals, the Court of Appeals held that the District Court Judge had misinterpreted its decision in *President and Directors of Manhattan Co.* v. *Kelby, supra,* and, applying the "ruling and rationale" of that decision to similar facts of the instant case, reinstated the Master's surcharge under the Second objection (RB. 149-155; 207 F. 2d 67-77).

THIRD OBJECTION. This objection involved six transactions of petitioner in accepting and cancelling Fifteenth Series bonds in lieu of cash collected by the Debtor on account of principal of mortgages in the Trust Fund (R. 63). Petitioner, under Article III, Section 1(h), of the Trust Agreement, had the right to accept for cancellation paid bonds of certain maturities in lieu of principal collections on Trust Fund mortgages (R. 299-300). These six trans-

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nent only to the questions whether the surcharges should bear interest at the full legal rate and whether petitioner should pay the expenses of the proceedings necessary to uncover its wrongs. Petitioner was charged with interest only at 3% and was not charged with the expenses (RB. 155-157). The Court of Appeals said: "The Trustee does appear to us negligent, whether we apply further descriptive adjectives or no" (RB. 156; 207 F. 2d 77). The degree of petitioner's negligence or wilfulness is indicated by its act on April 27, 1931, in releasing $525,450 cash as "excess", with full knowledge of the fact that mortgage collateral in the Trust Fund was in default in payment of principal for more than 60 days, and despite advice of its own counsel that the transaction was not authorized by the Trust Agreement, involved a "risk" and might subject petitioner "to a lawsuit" (F. 110, 112, 120, 121, 130, 205; R. 104-105, 158-159, 163, 165, 205). The degree of petitioner's negligence or wilfulness is also indicated by the transactions covered by the Third objection in authenticating bonds and then almost immediately accepting the same bonds for cancellation in lieu of cash collections on Trust Fund mortgages; transactions which the District Court and the Court of Appeals characterized as a "device to permit the debtor to retain cash which it should have deposited in the trust fund" (R. 263-264; RB. 163; 207 F. 2d 81).

actions, however, all occurred after January 2, 1932, the date the Guarantor of the bonds announced and notified petitioner that it would not pay principal of maturing bonds; three of the transactions occurred after the Debtor defaulted in payment of the bonds (F. 13, 14, 16; R. 128). The bonds, moreover, which petitioner accepted and cancelled in lieu of the cash, all were authenticated during 1932, they all matured in less than six months after the dates of authentication, they all were cancelled shortly after authentication and before maturity, and none had ever been issued or sold to the public (F. 222-242; R. 186-190).

The Master sustained the Third objection to three of the transactions and surcharged petitioner $3,966.68 (R. 238). The District Court Judge sustained the objection in its entirety and surcharged petitioner the full amount of $16,716.66 (R. 16), holding that "the authentication and cancellation of these bonds under such circumstances was merely a device to permit the Debtor to retain cash which it should have deposited in the Trust Fund" (R. 263-264). The Court of Appeals, agreeing with the District Court Judge that the transactions were a "device" to circumvent the Trust Agreement, affirmed (RB. 163; 207 F. 2d 77).

Summary of Argument

The petition lacks substantial grounds. The case does not have "particular importance far beyond the particular facts and parties involved".[4]

The case involved an interpretation of a trust instrument and turned upon findings of disputed facts made by a Special Master, accepted by the District Court Judge and the Court of Appeals; findings which petitioner here accepts (Pet., p. 13).

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[4] Address of the late Chief Justice Vinson to American Bar Association, St. Louis Daily Record, Sept. 8, 1949, col. 7.

Petitioner's assertions that the Court of Appeals disregarded the Trust Agreement, disregarded applicable State law, and applied their "highly personal views of socially desirable conduct" (Pet., p. 18) are without substance.

There is no intra-circuit conflict between this case and *Prudence-Bonds Corp.* v. *State Street Trust Company* (C. A. 2), 202 F. 2d 555, cert. denied, ... U. S. ....., 74 S. Ct. 47. The asserted conflict arises from differences in states of fact and is no ground for review on writ of certiorari.

ARGUMENT

I

The Court of Appeals did not disregard the Trust Agreement.

Petitioner, in support of its contention that the Court of Appeals disregarded the Trust Agreement, relies upon the clause, quoted *supra*, p. 7, providing for what petitioner calls "Certificates of Non-Default" (Pet., p. 8). Petitioner's contention is that this clause exculpated it from liability. The contention was rejected by the Master, the District Court Judge and the Court of Appeals (R. 114-118, 254-255; RB. 162-163; 207 F. 2d 80-81).

Petitioner has not stated the facts found below which it here accepts. The Trust Agreement clause petitioner relies upon provided that in releasing cash or securities petitioner "may accept as conclusive the written statement of any officer of the (Debtor) Corporation as to whether or not any securities deposited in the Trust Fund are in default in the payment of principal or interest" (R. 284). Petitioner, while stating that in connection with all but one of the Second objection cash releases "the Debtor furnished and the Trustee acted upon a certificate of an officer of the Debtor" (Pet., p. 9), has carefully refrained from saying that it received and accepted "as conclusive" certificates of the kind provided for by the Trust Agreement.

The facts found below are that in respect of one of the twelve Second objection cash releases petitioner did not receive any statement from the Debtor regarding the condition of the Trust Fund; in respect of five of the releases it received statements to the effect that none of the Trust Fund securities was "in default in the payment of principal or interest for sixty days or more"; in respect of the remaining six releases it received statements to the effect that none of the Trust Fund securities was "in default in the payment of principal for sixty days or more" (RB. 162; F. 208, 213; R. 183, 184).

Thus, in one instance petitioner did not receive any statement regarding defaults, in five instances it received one kind of statement, in six instances another kind of statement, and in no instance a statement of the kind provided for by the Trust Agreement, which explicitly required a "whether or not" statement regarding all defaults, both principal and interest, whether one or more days old.

Petitioner, moreover, had possession of the Trust Fund securities and knowledge of the terms thereof; it received each month a statement from the Debtor which informed it what principal and interest had been collected and not collected on the Trust securities; it recorded the collections in its books of account pertaining to the Trust. Petitioner had actual knowledge from its own records whether or not the Trust Fund contained defaulted securities (F. 57, 69, 75-79; R. 140, 144-145, 147-148).

The Master found, and the District Court Judge and the Court of Appeals accepted his findings, that on the date of each release of cash, Trust Fund mortgages were in default in the payment of principal for more than 60 days; that on the dates of certain of the releases mortgages were in default in the payment of interest; that petitioner had knowledge of the defaults; that the statements petitioner received "did not comply with" the Trust Agreement; that petitioner did not "accept as conclusive" any of the statements it received; and that petitioner "did not receive, in connection with any of the releases of cash enumerated in

the Second objection herein, any written statement of an officer of the Debtor as to whether or not any securities deposited in the Trust Fund were in default in the payment of principal or interest" (F. 145-148, 168, 169, 205-211, 213-218; R. 169-170, 174, 182-186). The Court of Appeals said (RB. 162; 207 F. 2d 81):

> "* * * Both the Master and the district judge found that the Bank did not accept these statements as conclusive. It had full knowledge of the default in the Hillman mortgage which we have set forth above; and it had full knowledge of the default in interest on the Elmhurst-Hampton mortgage * * * and that the entire principal was and had been callable * * *. Such exculpatory provisions should be 'strictly construed' * * *; and such knowledge might in any event be sufficient, whatever the notices. But it is apparent that * * * the notices were quite inadequate; * * *."

There is not the slightest foundation for petitioner's assertions that the Court of Appeals "baldly disregarded" the Trust Agreement, "flatly ignored the intent of the parties", and took the position "that the agreement between the parties can and should be disregarded and be replaced by the particular judges' own fluid concepts of the scope of an indenture trustee's obligations" (Pet., pp. 13, 15, 18).

The statement of the case, set forth above, and the thorough, well reasoned opinion of the Court of Appeals (RB. 142-164; 207 F. 2d 67) show beyond doubt that the Court of Appeals, applying established principles of construction, interpreted the Trust Agreement reasonably in accordance with its dominant intent and purpose, and, agreeing with the Master's findings of fact, held that petitioner had been negligent, had violated "explicit" provisions of the Trust Agreement, and should be surcharged for the loss its devastavits caused the Trust Fund. The Court of Appeals, quoting from and following its decision in *President and Directors of Manhattan Co.* v. *Kelby*, *supra*, involving a similar trust agreement and similar unauthorized releases of trust fund cash, said (RB. 154; 207 F. 2d 76):

> " * * * 'the release clause, as we have construed it, expresses the agreement's dominant purpose in the light of which its other provisions to which the Bank refers must be interpreted,' that dominant purpose being 'that the trust fund was equally to secure all the bonds.' This construction makes the entire agreement consistent and avoids 'an intention which verges on dishonesty.' It accords to the 60-day default provision the intent to assure speedy elimination of stale defaulted securities, rather than to increase the assets subject to withdrawal. And it avoids the anomaly of the district court's view, which requires the writing into this negative restriction of an affirmative grant neither stated nor implied. * * *
>
> * * * this seems to us a reasonable construction of the trust along lines already established by this court * * *."

Surely, this decision, involving an interpretation of a trust instrument and turning upon facts disputed by and found against petitioner by the Master, the District Court Judge and the Court of Appeals, does not present any substantial question meriting review by this Court.

II

The Court of Appeals did not disregard applicable State law.

Petitioner, arguing that the Court of Appeals disregarded applicable State law, cites only *Hazzard* v. *Chase National Bank,* 159 Misc. 57, aff'd 257 App. Div. 950, 282 N. Y. 652, cert. denied, 311 U. S. 708 (Pet., pp. 23-24).

The instant decision is plainly not in conflict with the *Hazzard* decision which involved a different set of facts and a different trust instrument. The trustee in the *Hazzard* case was saved from liability by an exculpatory clause of a type characterized as "particularly vicious" (159 Misc. 76), which limited liability to gross negligence and

bad faith; a provision not contained in the instant Trust Agreement (R. 273-317). As Judge Learned Hand said in *Manufacturers Trust Co.* v. *Kelby, supra* (125 F. 2d 650, 654):[5]

> "* * * The comments relied upon in *Hazzard* v. *Chase National Bank,* 159 Misc. 57, 287 N. Y. S. 541, affirmed 257 App. Div. 950, 14 N. Y. S. 2d 147, do not mean that such trustees should not be held to such of their liabilities as such as they do not succeed in evading by stipulations in the trust instruments; on the contrary they were made in reprobation of the extent to which they do succeed in escaping those obligations, while continuing to hold themselves out as trustees."

The Court of Appeals in the instant case, as its opinion shows, applied and followed its decision in *President and Directors of Manhattan Co.* v. *Kelby, supra,* where it applied and followed New York law (RB. 142-164; 207 F. 2d 67). The Court of Appeals said (RB. 151; 207 F. 2d 74):

> "* * * The situation seems to us to be controlled by both the ruling and rationale of *President and Directors of Manhattan Co.* v. *Kelby, supra,* 2 Cir. 147 F. 2d 465, involving the Fifth and Ninth Series of Prudence-Bonds."

Petitioner's contention that the Court of Appeals disregarded applicable State law is unsubstantial. Petitioner made no such contention in its petition to the Court of Appeals for rehearing (RB. 166-172).[6]

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[5] See also further comment of Judge Learned Hand about the *Hazzard* case in *Dabney* v. *Chase Bank,* 196 F. 2d 668, 671.

[6] In its petition for rehearing, petitioner contended only that the Court of Appeals had erroneously determined issues of fact whether Trust Fund mortgages were in default in payment of principal on the dates of certain of the Second objection releases of cash (RB. 166-172). In our answer to the petition we demonstrated that there was no merit to the contention (RB. 174-196). Petitioner here accepts the facts found against it below (Pet., p. 13).

III

There is no intra-circuit conflict between this case and *Prudence-Bonds Corp.* v. *State Street Trust Company* (C. A. 2), 202 F. 2d 555, cert. denied, ... U. S. ....., 74 S. Ct. 47.

Petitioner's statement that this case deals with the "identical issue" involved in the *State Street Trust Company* case and was determined "in precisely the opposite manner" with a "squarely conflicting result" (Pet., p. 15) is erroneous. The statement has no more substance than petitioner's charge that the Judges of the Court of Appeals disregarded the Trust Agreement and the law and applied their "highly personal views of socially desirable conduct" (Pet., p. 18).

The two decisions are not in conflict. The asserted conflict arises from differences in states of fact and presents no ground for the issuance of certiorari.[7]

The two cases are clearly distinguishable upon the facts.

The *State Street Trust Company* case involved a trustee's inaction or nonfeasance in failing to take timely steps to enforce a guaranty constituting part of the trust *res*. The Court of Appeals, Judge Frank dissenting, held that the trustee was immunized against liability by an exculpatory clause which the majority Judges construed "to give complete immunity to the Trustee for any nonfeasance in suing either the mortgagors or the Guarantor" (202 F. 2d 555, 564).

No such exculpatory clause is involved or was construed in the instant case. Petitioner has not been surcharged for inaction; it has been surcharged for misfeasance, for its negligent, unauthorized, affirmative acts in wrongfully releasing Trust Fund cash.

Manifestly, a provision immunizing a trustee from liability for failure to sue a mortgagor or guarantor does not

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[7] *Wisconsin Electric Co.* v. *Dumore Co.*, 282 U. S. 813.

relieve the trustee from liability for wrongfully releasing or disbursing trust fund cash.

Indeed, Judge Learned Hand in his majority opinion in the *State Street Trust Company* case specifically distinguished the two situations. He referred to his own decision in *Manufacturers Trust Co.* v. *Kelby,* supra (125 F. 2d 650, 653-654), and pointed out that a doctrine of New York law applying to a trustee's inaction in failing to take timely steps "to protect the *res* * * * did not apply to a breach that was a 'surrender or release' of any part of the *res*" by positive action (202 F. 2d 559). Judge Learned Hand there further said that bondholders "expect" that their indenture trustees will take "no action which will positively impair their interests" (202 F. 2d 564).

The absence of a conflict is further evidenced by the fact that the Court of Appeals in the instant case twice cited with approval the *State Street Trust Company* case (RB. 158, 162; 207 F. 2d 78, 81).

A further fact of special significance, particularly when considered in the light of petitioner's assertion that there is a "sharp" and "striking" conflict between the instant case and the *State Street Trust Company* case (Pet., pp. 3, 16), is that petitioner's counsel, in their petition to the Court of Appeals for rehearing, did not suggest, let alone assert, that the two decisions are in conflict; they indeed did not even mention the *State Street Trust Company* case (RB. 166-172).

In still another way it may be shown that there is no intra-circuit conflict.

The *State Street Trust Company* case was decided by Judges Learned Hand and Swan, with Judge Frank dissenting. The instant case was decided unanimously by Judges Chase, Clark and Frank who cited and followed the unanimous decision of Judges Swan, Clark and Frank in *President and Directors of Manhattan Co.* v. *Kelby, supra.* Thus, the instant unanimious decision of Judges Chase, Clark and Frank accords with the views of Judge Swan who concurred with Judges Clark and Frank in the *Presi-*

dent and Directors of Manhattan Co. case and with Judge Learned Hand in the *State Street Trust Company* case.

Furthermore, there have been three other unanimous decisions of the Second Circuit Court of Appeals in these same Prudence-Bonds Corporation accountings. *Central Hanover B. & T. Co.* v. *President and Directors of the Manhattan Co., supra,* was decided by Judges Learned Hand, Augustus N. Hand and Patterson; *Manufacturers Trust Co.* v. *Kelby, supra,* by Judges Learned Hand, Chase and Clark; *Brooklyn Trust Co.* v. *Kelby, supra,* by Judges Swan, Augustus N. Hand and Frank. Judge Frank participated in four of the six cases, Judges Learned Hand, Swan and Clark each participated in three of the cases, Judges Augustus N. Hand and Chase each participated in two of the cases, and the late Judge Patterson in one of them.

The Judges of the Second Circuit Court of Appeals are, therefore, especially familiar with the Trust Agreements and the issues involved in these accountings. This Court has four times declined to review their decisions in the cases.

All these facts and factors, coupled with the fact that the *State Street Trust Company* case, as Judge Learned Hand himself there pointed out, dealt with a factual situation materially different from that involved in the instant case and in the *President and Directors of Manhattan Co.* case, demonstrate conclusively that there is no basis for petitioner's statement that "there is a striking and continuing divergence in the views of various panels of the Second Circuit on the basic rules applying to trust agreements" (Pet., p. 16).

It plainly appears that there is no intra-circuit conflict. There is, therefore, no need to consider petitioner's further contention that the Court of Appeals should have heard the case *en banc* to "remove" the conflict (Pet., pp. 21-23). Petitioner, moreover, did not on the appeal or in its petition for rehearing suggest or request that the Court of Appeals sit *en banc* (RB. 166-172).

CONCLUSION

The petition for a writ of certiorari lacks substantial grounds and should be denied.

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Estate of Herman Gottlieb.

January 21, 1954.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1953

No. 516

CHEMICAL BANK & TRUST COMPANY,
Petitioner,

v.

PRUDENCE-BONDS CORPORATION (New Corporation), *et al.,*
Respondents.

REPLY MEMORANDUM FOR PETITIONER CHEMICAL BANK & TRUST COMPANY

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REPLY MEMORANDUM FOR PETITIONER CHEMICAL BANK & TRUST COMPANY

Since the carefully selected facts set forth in respondents' brief in opposition may obscure the basic question presented, petitioner Chemical Bank & Trust Company is compelled to file this reply memorandum. The issue for this Court's decision is squarely and properly presented in the petition for certiorari. Cardinally, the question is whether the reasonable terms of the trust agreement, adopted in good faith and acted upon by the parties, may be disregarded, as they were by the Court of Appeals.

The question is graphically framed by the handling below of the Second Objection. This objection, which involves the bulk of the surcharge and has been the focal point of the proceedings, challenged the propriety

of several releases of excess cash collateral to the debtor Prudence-Bonds Corporation. As was shown in the hearings before the special master, the trust agreement, as made and consistently followed by the parties, called for the exclusion only of mortgages in default *in the payment of principal for more than sixty (60) days* in determining whether there was excess collateral in the trust fund subject to withdrawal. See petition for certiorari, pp. 7-8.

In the whole of their brief, respondents do not even mention this settled construction of the trust agreement, nor the "clear day" when the trust fund was in balance which resulted from its application. This area is completely passed over by respondents, despite the plain fact that it forms the framework of the litigation and accounts for over $900,000 of the total surcharge imposed of $1,061,966.66 (and for a corresponding portion of the more than $700,000 in interest). Although respondents in the brief in opposition discuss facts and findings for several pages, they do not—and cannot on the record—suggest that the special master or either court below found that this was not the settled construction of the trust agreement.

Indeed, the case was tried and briefed before the special master—by all parties to the proceeding—upon the uncontested premise that, in determining whether there was excess collateral in the trust fund, mortgages in default for less than the 60-day period or in default solely as to interest were included in the trust fund.[1]

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[1] Respondents also accepted this construction in proceedings in connection with the Fourteenth Series of Prudence-Bonds.

The Second Objection, as stated by respondents Prudence-Bonds Corporation and the Reorganization Trustee in their formal objections to petitioner's account, was based on this settled construction of the trust agreement.

Thus respondents objected to the releases on the alleged ground that at the time of each release a mortgage in the trust fund was "in default in payment of principal for more than sixty (60) days . . ." (R. 61). Similarly, respondents did not object to three withdrawals aggregating $59,900 which, thereafter, left the fund equal to the bonds outstanding only if the fund included mortgages in principal default for less than sixty days. Clearly, respondents too recognized the settled construction of the trust agreement.

The District Court, in holding that there was a "clear day" on June 4, 1931, concluded that the construction acted upon by the trustee and the debtor was the one plainly called for under the terms of the trust agreement which, as the District Court opinion points out, provided that if any of the securities deposited in the trust fund *"shall be in default in the payment of principal for more than 60 days the Corporation shall be permitted to withdraw only such securities . . . as shall be so in default . . ."* (R. 256-258; emphasis in original).

Finally, and most important, the Court of Appeals did not resolve this paramount issue against petitioner by reliance on facts or findings contrary to petitioner's position. On the contrary, the Court of Appeals consciously and explicitly ignored the intent of the parties and the meaning of the trust agreement. There

can be no argument on this score. As the Court of Appeals stated:

> "It may be noted that the Bank urges vigorously a settled construction of the trust agreement made and acted upon by the parties at the time, contrary to our conclusion and in accord with the view of the district judge. But the parties were the Trustee and the debtor corporation; overlooked entirely are the bondholders for whom the protective provisions were drawn." (207 F. 2d 67, 77) [2]

In short, as the petition states and as the decision below itself plainly demonstrates, the panel of the Court of Appeals which sat in this case disregarded the reasonable terms of the agreement and surcharged the trustee, in the words of Judge Frank in his dissent in the conflicting *State Street Trust Company* case, on "the court's notion of . . . socially desirable conduct" and "entirely without regard to the parties' intention."

The welter of facts catalogued by respondents cannot serve to change the posture of this litigation. It is not the function of this memorandum to retrace the continuing conflict among the panels of the Court of Appeals for the Second Circuit or the other points covered in the petition for certiorari. It is designed only to point out that the question—of consuming importance

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[2] As set forth in the petition for certiorari (pp. 15-16), Judge Learned Hand, in the *State Street Trust Company* case, concluded that protection of the bondholders' interest, used as the basis for disregarding the terms of the trust agreement here, did not require or justify the court's refusing to give effect to the agreement between the debtor and trustee.

to the financial community and bondholders everywhere —is cleanly presented on this record and is in need of determination by this Court.

Respectfully submitted,

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